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C O N F I D E N T I A L SECTION 01 OF 02 TOKYO 001757

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SUBJECT: DPJ FISCAL POLICY -- AMBITIOUS SPENDING, UNCERTAIN FINANCING

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Classified By: CHARGE D'AFFAIRES JAMES P. ZUMWALT FOR REASONS 1.4(B),(D)

¶1. (SBU) SUMMARY. The release of the Democratic Party of Japan's "manifesto" (platform) and accompanying policy index have given a better sense of the party's fiscal priorities as well as its specific spending and financing plans. As reported (reftel), the DPJ's proposed fiscal policy contains a strong strand of economic populism. The DPJ would undertake phased expenditure increases, focused on the household sector, from FY10. These increases would culminate in JPY 16.8 trillion (USD 177 billion or 3.4% of Japanese GDP) in annual spending starting in FY13. The DPJ plans to finance nearly 80 percent of this through two sources: "cuts in wasteful government spending" and surplus funds in special accounts. It is far from clear whether these sources will in fact deliver the targeted revenues, and Finance Minister Kaoru Yosano of the Liberal Democratic Party (LDP) has mocked the DPJ, noting that "it is fun to play in the world of imagination and fantasy." END SUMMARY.

DPJ Spending Plans

¶2. (SBU) The DPJ proposes increasing spending over a four-year period (FY10-13) to a total of JPY 16.8 trillion annually. Although details remain sketchy, the DPJ's spending plans focus largely on the household sector. In particular, the party calls for:

-- abolishing road-related tax surcharges on gasoline and automobiles which currently generate about JPY 2.5 trillion in annual tax revenues (to be fully implemented in FY10);

-- eliminating highway tolls except in congested Tokyo and Osaka (to be phased in from FY10);

-- an annual subsidy of JPY 120,000 (USD 1,260) for each high school student to help pay high school tuition (which is not free in Japan)(to be fully implemented in FY10);

-- an annual allowance of JPY 26,000 (USD 270) per month for each child through middle school (JPY 13,000 in FY10 and raised to JPY 26,000 from FY11); and

-- the introduction of a new income support program for farmers designed to make up the difference between cost of production and sales price through a government subsidy.

¶3. (SBU) The combined size of the subsidy for high school tuition and the child allowance program is approximately JPY

3.1 trillion (USD 33 billion or 0.6 percent of Japanese GDP) in FY10, and is likely to have a macroeconomic impact on growth similar to personal income tax cuts. Notably, these programs do not appear to have an income ceiling, even though the DPJ criticized an earlier LDP cash handout program on that basis. It is also worth noting that the abolishment of both road-related tax surcharges and highway tolls could be viewed as inconsistent with the DPJ's separate target of reducing greenhouse gas emissions by 25 percent from 1990 levels by 2020.

¶4. (SBU) With respect to pension reform, the DPJ plans to introduce a minimum monthly benefit of JPY 70,000 (USD 740) per person after integrating three programs -- the national pension program for the self-employed, the employees' pension program, and the mutual aid pension program for government employees. The necessary revenue for the minimum benefit payment will likely be financed by an increase in the consumption tax in four years. The DPJ plans to develop a detailed pension reform proposal in FY12 and complete the necessary legislative action in FY13.

DPJ Financing Plans

¶5. (SBU) The DPJ has said that it does not plan to issue additional debt and has instead identified four revenue sources for these expenditure increases: (1) "cuts in wasteful government spending"; (2) surplus funds in special accounts; (3) tax increases; and (4) sales of government assets. The first two sources are the most important and the most contentious. Firstly, the DPJ plans to secure JPY 9.1 trillion (USD 96 billion and 54 percent of the total) by overhauling government spending. This is a significant figure, equivalent to 1.8 percent of GDP or 10.3 percent of

the initial FY09 general account budget. Specifically, the DPJ plans to squeeze out about JPY 6.1 trillion (USD 64 billion) by cutting government subsidies and grants, and JPY 1.3 trillion (USD 14 billion) but cutting government public works projects. Personnel expenses for government employees would be cut by 20 percent, or JPY 1.1 trillion (USD 12 billion).

¶6. (SBU) Secondly, the DPJ plans to raise JPY 4.3 trillion (USD 45 billion or 26 percent of the total) by using surplus funds in two central government accounts: (1) the Fiscal Loan Fund (FLF) Special Account, created to finance the Fiscal Investment and Loan Program (FILP); and (2) the Foreign Exchange Fund (FEF) Special Account, created to manage Japan's foreign exchange reserves.

-- The FLF Special Account earns approximately JPY 2-3 trillion (USD 21-32 billion) in net interest income annually, derived from the spread between lending rates to FILP-affiliated organizations and the interest rates paid on FILP bonds (which are Japanese sovereign debt). The FLF Special Account has been nearly drained to fund the Aso Administration's fiscal stimulus. Its accumulated surplus is projected to total about JPY 3.4 trillion (USD 36 billion) at the end of FY09.

-- The FEF Special Account generates about JPY 3-4 trillion (USD 32-42 billion) in net interest income annually, derived from the spread on investment in foreign currency-denominated assets over interest payments on short-term yen financing bills. In recent years, the Ministry of Finance has used nearly half of this net interest income to finance the general account budget. The other half has been set aside as a cushion against the risk of future interest rate and exchange rate fluctuations.

¶7. (SBU) The remaining 20 percent of total financing for the DPJ's increased expenditures is to come from JPY 2.7 trillion (USD 28 billion) in tax increases and JPY 0.7 trillion (USD 7 billion) in the sale of government assets. The DPJ is

considering abolishing the existing spouse and dependent allowances for the personal income tax (which would to some extent offset the impact of the high school tuition subsidy and child allowance program), and eliminating or reducing preferential tax treatment for designated industrial sectors. The DPJ plans to keep the consumption tax at five percent for the next four years.

LDP Reaction

¶8. (SBU) Finance Minister Yosano has taken the lead for the LDP in criticizing the DPJ's fiscal policy, in particular the lack of realism of the revenue sources. On July 6, he said of the DPJ: "It is fun to play in the world of imagination and fantasy," and that "it is nearly equal to committing a crime, as the DPJ is tricking people into thinking their livelihoods would be ensured." On July 27, Yosano charged that the DPJ manifesto was devoid of any discussion of macroeconomic policy or growth, and that the Japanese financial system would "fall into ruin" under a DPJ government. Chief Cabinet Secretary Takeo Kawamura also characterized the DPJ's economic policies as "irresponsible." Minister of Administrative Reform Akira Amari called the DPJ manifesto "the height of populism" and that, "if such things continue, Japan will have to be shut down."

9.(C) COMMENT. If implemented, the DPJ's fiscal plans are likely to result in a short-term boost to domestic demand from higher consumption given the clear focus on households. However, the realism of the revenue sources -- particularly obtaining nearly two percent of GDP from "cuts in wasteful government spending" -- is questionable. There is also no meaningful discussion of measures to attain a higher rate of trend economic growth or return to fiscal sustainability, issues which are central to Japan's medium-term economic health. END COMMENT.
ZUMWALT